

10 years later, Amazon celebrates Prime's growth

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For shoppers, Amazon Prime often comes through, delivering that last-minute purchase for an almost forgotten birthday or an overlooked necessity for vacation travel.

Last week, Prime came through for Amazon itself.

For much of 2014, Amazon.com's stock had been in doldrums, shedding a quarter of its value as investors fretted about either skimpy profits or too-frequent losses. On Thursday, Amazon reported a \$214 million profit in the fourth quarter, slim given the company's \$29.3 billion in sales. But the black ink was well ahead of analyst expectations.

In the earnings announcement, Amazon founder and Chief Executive Jeff Bezos highlighted the rapid growth of Prime, which marked its 10th anniversary Monday. He noted that the \$99-a-year service, which offers shipping on millions of products at no additional cost, boosted its worldwide paid membership 53 percent last year - "50 percent in the U.S. and even a bit faster outside the U.S."

Amazon stock soared on the news, regaining \$20 billion Friday and nearly \$5 billion more Monday, closing at \$364.47, up \$9.94.

There were few outside Amazon who believed that Prime could be the engine it has become when it debuted 10 years ago. On Feb. 2, 2005, Amazon rolled out the service with a note from Bezos, greeting shoppers on the home page of the company's website.

"We expect Amazon Prime to be expensive for Amazon.com in the short term," Bezos wrote. "In the long term, we hope to earn even more of your business, which will make it good for us too."

Not everyone understood the strategy. Many on Wall Street worried about the hit the company would take on expenses, boosting order-fulfillment costs with a service that could never cover the shipping charges Amazon could incur.

"Skeptics thought we were crazy," said Amazon Vice President Greg Greeley, who runs the service. "At the time, they said 'Why would anybody want to spend that much for shipping?' and 'How the heck are they going to be able to afford it?'"

It took some time, as Bezos suggested, but Prime has proved those doubters wrong. The service has moved from a shipping program to the heart of Amazon's retail strategy.

"It's absolutely core to our retail business," Greeley said.

Prime started when an Amazon engineer named Charlie Ward pitched the idea in a digital employee-suggestion box. At the time, Amazon offered customers free shipping on purchases of \$25 or more, as long as they were willing to wait a few extra days for their order to arrive. Ward thought some customers would be willing to spend more, and might even shop more often if they could be part of a buying club that offered rapid shipping.

Bezos seized on the idea and pulled together a group of executives in November 2004 in the boathouse at his home. He told them to come up with a proposal by Amazon's next earnings call, at the end of January.

"We knew we were building something that was going to be new and

different," said Greeley, who was at that planning meeting a decade ago. "We knew we were onto something."

At first, Prime was purely about shipping speed. Amazon had used computer smarts and supply-chain logistics to create a warehouse system that could quickly locate individual items from the millions it had in stock, box them up and ship them quickly to customers.

"Very few people were using two-day shipping," which cost a premium back then, Greeley said. "That was truly an indulgence."

But when Amazon launched Prime, "tens of thousands" of customers signed up in the first month, agreeing to pay the \$79 yearly fee, Greeley said.

Last March, the company boosted the membership fee by \$20. Even so, four out of five of those initial members are still Prime subscribers, Greeley said.

Amazon won't disclose the number of Prime subscribers, though the company has given various hints. When it announced financial results last week, Bezos said in a statement that Prime grew 53 percent worldwide. A year earlier, the company said it had "tens of millions" of Prime subscribers.

Those data points, and other research, have led analysts to peg the number at 40 million members or more worldwide. So conservatively, Amazon is generating \$4 billion from Prime members on just the \$99-a-year member fees alone.

But that's hardly what makes Prime such a lucrative business. Prime changes customer behavior.

When shoppers shell out \$99 to be Prime members, they often spend the rest of the year trying to justify that purchase. If they see a pair of shoes they like for roughly the same price on Amazon.com and another site, they'll often buy from Amazon to validate that membership.

"When a customer becomes a Prime member, they do step up their purchases considerably," Amazon Chief Financial Officer Tom Szkutak said in a conference call with journalists after the company reported results last week.

Amazon won't disclose how much more they shop, but Consumer Intelligence Research Partners, which tracks Prime data, believes members spend 2.5 times as much as non-Prime customers. What's more, the firm believes those members account for about two-thirds of Amazon retail revenue in the United States.

"It stands to reason that once a customer signs up for Prime, they start to behave differently," said Michael Levin, a partner at the research firm. "We suspect strongly that an Amazon Prime member spends their first year trying to justify the \$99 cost, mostly in terms of free shipping, and spends to that level."

Four years ago, Amazon realized it could boost membership by adding new benefits to Prime.

In February 2011, Amazon bundled in its Netflix-like video-streaming service, Prime Instant Video. Nine months later, it added the Kindle Owners' Lending Library to Prime, letting Prime subscribers who own Kindle e-readers borrow thousands of digital books at no additional cost.

At the time, Greeley said, Prime had "millions" of members. The new benefits triggered a rapid uptick. A survey of 1,774 members last September by the investment firm RBC Capital Markets found that 10.1

percent of Prime members said unlimited video streaming was the "most important" reason they signed up for Prime.

"Perhaps Amazon knows what it's doing with this Prime unlimited streaming video thing," RBC analyst Mark Mahaney wrote in the report.

Amazon continues to find new features to add to Prime, adding offerings such as unlimited photo storage or a subscription music service. At the same time, Amazon offers free trial memberships for customers who purchase gadgets such as its Fire tablets.

RBC's Mahaney believes the growth of Prime might help resolve one of the most long-standing Amazon investor gripes - skimpy profit margins. He thinks Prime could have between 55 million and 85 million members by 2016. That could mean as much as \$8.5 billion in revenue, just from membership fees.

While Amazon is likely to pump much of those dollars back into its business, it's also getting new revenue from last March's price increase.

Amazon isn't about to become a profit machine. But as Prime approaches its teens, it may well help Amazon deliver margins that have long been elusive.

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